3. Sharing Dilutes Efficiency Incentives And Should Be Eliminated. (Baseline Issues 4A, 4B)

Elimination of sharing is necessary to provide appropriate incentives for investment and to promote economic growth. Sharing was implemented in the LEC price cap plan as a temporary backstop for unanticipated errors in productivity;[77] it was not a means of determining whether prices were just and reasonable. SWBT supports elimination of both sharing and the automatic lower formula adjustment mark (LFAM). The central focus of price cap regulation is on the reasonableness of changes in the overall price levels (as determined by the overall price cap on the aggregate of regulated services), not on earnings. The sharing provision maintains a focus on earnings and costs, which runs counter to the goals of price cap regulation.

At the margin, elimination of sharing encourages investment in the regulated portion of the telecommunications sector because companies look for and shareholders require the opportunity to earn a return on investment corresponding to the level of risk. Elimination of sharing removes the perverse incentives embedded in cost-based ROR regulation as outlined below. First, if regulation presents a significant danger that the benefits of productivity increases will be eliminated because a carrier's earnings, in retrospect, will be found to be

[77] The Commission was concerned that a single industry-wide productivity offset may not be accurate for an individual LEC. The Commission viewed the sharing backstop as temporary "at least until we acquire additional experience with LEC price caps." Since then, the Commission has found price caps effective in regulating AT&T's less competitive services, gaining valuable experiences with this new form of regulation over an extended time. In addition, the Commission has over three years' experience with LEC price cap regulation. During this time, unexpected, extreme situations have not arisen with LEC price cap regulation. While there was some variance in earnings among the price cap LECs as might be expected, the price cap LECs have not experienced the extremely high earnings of the type against which the sharing backstop safeguard was implemented. Moreover, accounting earnings are misleading.

"unreasonably high" and rates have to be decreased via the sharing mechanism, then incentives to behave efficiently and to innovate are severely weakened. SPR has shown that efficiency incentives present in the Commission's current hybrid price cap/sharing plan are only fractionally better than what existed under ROR regulation.[78] SPR estimates the current price cap plan with sharing has approximately 18 percent of the efficiency incentives provided in unregulated competitive markets, just slightly higher than the 14 percent under rate of return regulation. The optimal level of incentives is estimated by SPR to be about 63 percent, a result which requires the elimination of sharing, among other improvements.

Second, the sharing mechanism together with investors' expectations force management to invest shareholder funds in other lines of business where earnings regulation is less restrictive or nonexistent (i.e., allowing the market to determine returns to investment.) Competitive capital markets and sound financial management require that firms pursue projects with the highest possible returns for a given level of risk.

Third, the sharing mechanism maintains the need for a determination of appropriate business costs and cost allocation procedures. Thus, sharing may create a perverse incentive not to lower expenditures in situations when cost reductions might otherwise result in sharing. Elimination of the sharing and LFAM benefits customers as well by placing the risk of investments with shareholders.

Fourth, as markets become more competitive and services are removed from price cap regulation, there is no satisfactory method of applying cost allocations and sharing. The Commission acknowledges the benefits of a price cap system that imposes no sharing obligation.

---

[78] SPR, pp. 22-23.

If sharing is retained, the Commission would have the virtually impossible task of developing a series of cost allocation procedures for price cap versus non-price cap services, to ensure against the possibility of cross-subsidization of competitive services by the remaining price cap regulated services. Commissioner Barrett has noted:

> as long as we impose an overall rate of return ceiling, we must either regulate the prices of all services, even if it's only incidentally through the imposition of a cap, or we must engage in some sort of cost allocation scheme between those services we regulate and those we don't."[79]

These allocations would be unnecessarily burdensome and arbitrary, possess little or no relationship to the actual costs of each service, and be a constant source of contention and needless regulatory gaming. There is no good way to make the needed transition of competitive services from price cap regulation as long as the sharing mechanism is maintained.

Fifth, if a LEC is in the sharing zone, then the returns it may realize from the successful introduction of new services are limited. Sharing provides disincentives to undertake costly and risky investment in research and development of new services, discouraging the introduction of new services.

Sixth, elimination of sharing alleviates concerns about the alleged manipulation of earnings subject to sharing that has prevented regulatory reform on a number of fronts. For example, the Commission precluded the price cap carriers from utilizing the Price Cap Carrier Option in the depreciation simplification docket (CC Docket No. 92-296), based primarily on concerns that the LECs would choose depreciation rates based on expected earnings levels.

---

[79] "Beyond Price Caps: Escaping the Traditional Regulatory Framework," Commissioner Andrew C. Barrett, Federal Communications Commission, Speech to the Florida Economics Club, August 27, 1992 (<u>Barrett Speech</u>), p. 7.

Elimination of sharing should remove the last remaining barrier to allowing the price cap LECs to control their depreciation rates (as was envisioned when the Commission previously ruled in the LEC Price Cap Order that depreciation rate changes were endogenous.)[80] Also, as the Commission noted in the Affiliate Transactions NPRM, a price cap plan without sharing (as applied to AT&T) "greatly reduces the incentives that AT&T may have to shift costs between its nonregulated operations and its carrier operations."[81] The same benefits from a lack of sharing exist for the LEC plan.

Seventh, elimination of sharing would remove a great deal of complexity in the LEC price cap plan. Significant resources are currently required by the price cap LECs, the Commission and other parties to accomplish compliance with and regulatory oversight of the sharing adjustments. Sharing requires cost-of-service based calculations within a hybrid ROR regulation/price cap regulation framework. The current approach is much more complex than is necessary.

Eighth, use of a pure price cap plan is consistent with the Commission's goal to foster competition and stimulate greater productivity. A price cap carrier that increases

---

[80] LEC Price Cap Order, paras. 182-187.

[81] Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, Notice for Proposed Rulemaking, CC Docket No. 93-251, released October 20, 1993, (Affiliate Transactions NPRM), para. 101. SWBT further submits that the elimination of sharing would eliminate the perceived need to strengthen affiliate safeguards proposed in CC Docket No. 93-251. As noted on pages 6 and 7 of SWBT's comments in CC Docket No. 93-251, "the adoption of price cap regulation, which as the Commission acknowledged in the BOC Safeguards Order, 'complements' the cost allocation reporting and enforcement safeguards 'to reduce BOC incentives to cross-subsidize.'"

productivity and efficiency can retain more earnings. This incentive to reduce costs, not increase them, is further reinforced with the elimination of sharing.

Finally, the retention of sharing and LFAM is not necessary to alleviate concerns regarding confiscation.[82] If a particular LEC's performance under the price cap plan deteriorates significantly, that carrier should retain the ability to file tariffs proposing rate changes. A means to address severe drops in the economic performance of the price cap plan for unusual situations that would harm customers as well as stockholders would provide acceptable assurance that carriers would be allowed to deliver high quality service and maintain universal service obligations. This adjustment would not be automatic, as is currently the case with the LFAM.

4. Common Line Cost Recovery Should Be Changed. (Baseline Issues 5A, 5B, 5C, 5D)

The Commission requests comments on the price cap rules affecting common line charges. The questions in the NPRM, as presented, miss the point. Because the costs of common lines are non-traffic sensitive and caused by end users requesting access to the network, end users should pay for these costs. As such, the current CCL rate elements that are paid by IXCs, which represent a support mechanism, could be eliminated. The Commission's rules mandating the recovery of end user costs through carrier common line charges to IXCs place the LECs at a competitive disadvantage in access markets and perpetuate the uneconomic pricing

---

[82] However, the need for a means of addressing potential severe drops in the economic performance of the price cap plan for an individual carrier exists in order to refrain from violating Constitutional prohibition against unreasonable confiscation. Bluefield Water Works & Improv. Co. v. PSC, 262 U.S. 679 (1923), Federal Power Commission v. Natural Gas Pipeline Company, 315 U.S. 575 (1942), United States of America v. FCC, 707 F.2d 610 (D.C. Cir. 1983).

levels found in today's access prices. The economically sound answer to the several questions posed by the Commission is to provide the LECs with the flexibility to increase End User Common Line (EUCL) charges and reduce CCL rates. If all end user-related costs are not going to be recovered from end users, the Commission must develop an equitable and competitively neutral method to recover those common line costs through the use of a support mechanism.

SWBT recommends that a transitional plan be developed which permits LECs the flexibility, over time, to increase EUCL charges. As an interim step, the Commission should implement rules which permit the flexible recovery of common line costs from end users. For example, these residual common line costs could be recovered through a flat-rate, bulk-billed mechanism rather than the existing usage-based CCL charges. Likewise, the Commission should also implement rules giving LECs the necessary flexibility to recover Long Term Support (LTS) through a similar bulk-billed arrangement.

SWBT supports the inclusion of any common line cost recovery method in a public policy basket. Also, in order to facilitate flexible recovery of common line costs, the Commission should modify the common line price cap index and the related calculation of the maximum CCL rate.

The Commission's original intent in designing the common line price cap rules was to allow price cap LECs to retain half of the benefits of the relevant demand growth.[83] The relevant demand growth is the growth in minutes of use (MOU) that is above the growth

---

[83] "We do wish to provide incentives for greater productivity in the provision of common line as well as other access elements." LEC Price Cap Order, para. 58.

in access lines. The retention of the benefits realized from demand growth is an important source of productivity.

The Commission previously reasoned that nontraffic-sensitive costs grow in step with access lines and was concerned that recovery of these costs in the CCL rate element on a per MOU-basis would result in windfall revenues for the LECs. The Commission concluded that the benefits of demand growth should be shared between the price cap LECs and their customers allowing the LECs to keep the benefits of half of the growth in minutes per line.[84]

In order to facilitate an orderly transition of the price management of common line rate elements, SWBT recommends a single two-part change to the Common Line price cap index treatment:

1) Apply the demand adjustment (g/2) in the Common Line price cap index to only the fraction of Common Line revenue that is recovered on a per minute basis.[85]

2) Calculate compliance with the Common Line price cap using the calculation of an Actual Price Index (API) for common line rate elements, including the proposed End User Common Line (EUCL) rates.[86]

This proposed change is computationally much simpler than the current treatment. This change results in maximum CCL rates equal to those under the current rules as long as the CCL rate elements are charged on a per MOU basis. Importantly, the proposed change makes a measured

---

[84] LEC Price Cap Order, para. 69.

[85] This requires multiplying the "g" in the Common Line PCI formula by a fraction "s" in two places in the PCI formula, where "s" is the percent of Common Line revenue recovered on a per minute basis as a share of total Common Line revenue. In keeping with existing price cap mechanics, the revenue share "s" would be calculated using base period demand times price. This modifies Part 61.45(c).

[86] Thus, Part 61.46(a) would apply to the common line rate elements included in the public policy basket for price management purposes.

and orderly transition to a simplified price cap index when a LEC begins charging CCL on other than a MOU basis. A LEC that has no common line costs being recovered on a per MOU basis has no reduction in the PCI due to the demand adjustment portion of the formula (i.e., "sg/2"). Otherwise, the demand adjustment reduction in the PCI continues to apply.

The effect of the first part of this change is to ensure that the demand adjustment -- which is a concern for only that portion of Common Line revenue that grows when minutes grow -- applies only to per-minute common line revenue. The effect of the second part of this change is to eliminate the subtraction formula in Part 61.46(d), replacing it with the more straightforward API calculation in Part 61.46(a). Both changes are needed together to accomplish SWBT's proposal, and SWBT strongly opposes making the second part of this change without the first part.

A serious concern is that, given the complexity of the Common Line price cap index calculations and interactions between various possible revisions, the price cap LECs could inadvertently be made significantly worse off under certain options, while that worsening may be difficult to demonstrate. For example, the simple move to recovering the existing CCL revenue on a per-line basis sacrifices some amount of potential revenue growth. Placing the Common Line PCI on a per-line basis also sacrifices potential revenue growth, costing the price cap LECs the equivalent of almost a full percentage point on the overall productivity offset.[87] Either of the changes mentioned in this paragraph are unacceptable if made mandatory.

SWBT is strongly opposed to any revisions to the Common Line price cap rules that are not strictly and fully accounted for in other offsetting adjustments to the price cap plan. SWBT's changes recommended herein accomplish this necessary balancing, facilitate voluntary anticipated changes in rate design and continue to achieve the Commission's original objectives.

5. No Changes To The Exogenous Mechanism Should Be Made. (Baseline Issues 6A, 6B, 6C)

The NPRM suggests a narrowing of the list of items considered for exogenous treatment. Specifically, the NPRM suggests including only those accounting changes that are accompanied by changes in economic costs. SWBT strongly opposes such a suggestion.

The Commission has historically recognized changes in accounting as appropriate exogenous adjustments in a regulatory regime based on accounting costs. The Commission currently regulates common carriers based on accounting costs, not on economic costs. When Part 32 was implemented, the Commission's accounting rules were premised on generally accepted accounting principles (GAAP).[88] GAAP accounting was supported for reasons of consistency and comparability between regulated and nonregulated companies, better

---

[87] The LEC Price Cap Order concluded that the long-term productivity offset would be reduced by about 0.67 percentage points by requiring a per-line common line price cap formula. LEC Price Cap Order, para. 94. The Commission also states: "We estimate that the 2.8 percent baseline productivity offset using the balanced 50-50 formula is equivalent to a 3.5 percent offset under the originally proposed formula at 8 percent demand growth." Id., fn. 107. Circumstances particular to a LEC can cause the effect to be even greater.

[88] Part 32, para 32.1. See also Revision of Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, 102 F.C.C. 2d 964 (1985), para. 2.

measurement of financial performance and proper matching of revenues and expenses. In addition, initial rates set under price caps were based upon the then-current GAAP accounting costs.

Sidestepping GAAP changes, as suggested in the NPRM, fails to reflect the recognition of liabilities and the appropriate period of cost recognition. Some GAAP changes represent a change in the timing of when costs are recorded. These changes properly match the cost of services with the revenues they help generate during each period. To narrow exogenous cost treatment to only those changes that have an economic (i.e., cash flow) impact would ignore the true costs of providing service in the applicable time period. Instead it would delay recognition of those costs until such time as cash is expended. Recognizing GAAP changes for exogenous treatment allows for the potential recovery of those costs through changes to the price cap index over the actual time period that those costs provide benefits to customers. Recognizing only economic cost changes for exogenous cost treatment could cause large fluctuations in the price cap index based upon the timing of cash payments. Moreover, the Commission could be required to perform the impossible task of developing a new set of rules to determine economic costs as opposed to accounting costs.

In addition, it would be contradictory to be regulated based upon GAAP accounting, but ignore the effects of future GAAP changes. Because the price cap LECs have been regulated based on accounting costs,[89] changes in accounting costs have resulted in changes in the basis on which LECs' performance has been evaluated. If accounting costs were

[89] Under ROR regulation, prices are set to cover accounting costs. In the current LEC price cap plan, past sharing amounts were determined based on accounting costs.

understated due to the fact that they were established at levels below economic costs, then regulated prices were also set artificially low because they were based on the level of accounting costs. The current price cap plan still has its roots in historically-determined accounting costs to the extent that any major deviations between accounting costs and economic costs still exist. Thus, SWBT vehemently opposes the suggestion in the NPRM that the list of items for which exogenous adjustments are considered be narrowed. Price cap indexes should be adjusted for any major changes in accounting costs.

Furthermore, most nonregulated companies comply with GAAP. These companies are free to reflect accounting cost changes in the prices they charge their customers even before such accounting rulings become official. With increasing competition in telecommunications, the LECs likewise should be allowed the ability to include GAAP accounting cost changes in the prices they charge.

Appendix EXOG displays the exogenous adjustments that have been made to the price cap indexes of the price cap LECs since January 1, 1991. For ease of use with the rules, the exogenous adjustments are grouped by section of the rules that gave rise to the adjustment. Clearly a number of the changes have been made based on changes in the levels of accounting costs, not changes in economic costs. The majority of these exogenous adjustments have resulted in reductions in price cap indexes, rather than increases. An example of the inappropriateness of the NPRM's suggestion is that changes in separations rules do not result in a change in the underlying economic costs, but do change the accounting costs assigned to the interstate jurisdiction.

Also, it is important to retain the ability of the regulated carrier to request and receive rate recovery for the fulfillment of newly imposed regulatory obligations. Compliance with fiats, whether established by legislation or specific regulation, is not cost free. To the extent that regulatory and legislative actions impose significant costs on a regulated firm, the regulatory body retains an obligation to provide some specific mechanism for recovery of those costs. Currently, the exogenous cost mechanism is that vehicle.

The Commission asked whether access customers or other groups should be allowed to initiate exogenous cost requests. No rules changes are needed. Current rules and procedures allow any party to suggest Commission action on any subject, including appropriate exogenous adjustments. As Appendix EXOG clearly demonstrates, the Commission's current rules and procedures have resulted in a significantly greater amount of exogenous reductions in price cap indexes compared to the increases. The Commission should <u>not</u> impose any kind of automatic exogenous cost request review process that would subject price cap carriers to a litany of filing requirements simply to defend unfounded allegations that each rate element is not based on some arbitrary form of cost-of-service based pricing. Customers and other parties have the formal complaint process and can suggest that the Commission initiate other proceedings on its own initiative, if necessary.

6. <u>Regulatory Symmetry Must Be Afforded To All Market Participants</u>. (Baseline Issues 9A, 9B)

The <u>NPRM</u> requests comments on where regulatory symmetry should be achieved. The Commission has recently stated that:

> competitors providing identical or similar services will participate in the marketplace under similar rules and regulations. Success in the marketplace thus should be driven by technological innovation,

> service quality, competition-based pricing decisions and responsiveness to consumer needs -- and not by strategies in the regulatory arena. This even-handed regulation, in promoting competition, should help lower prices, generate jobs, and produce economic growth.[90]

SWBT believes that regulatory symmetry must be afforded to all market participants. (Baseline Issue 9B) Price cap regulation should not revert to some form of cost-based ROR regulation by increasing the regulatory requirements to demonstrate individual cost changes. Instead, the Commission should adopt a plan similar to the AT&T price cap plan. All telecommunications providers in a given market should be subject to equivalent regulatory scrutiny. The Communications Act makes no distinction between carriers or classes of carriers (e.g., the Commission's dominant/nondominant distinction). Accordingly, no support is contained in the Act justifying disparate regulatory treatment between providers in like markets.

If a situation can be determined where legitimate public interest requires asymmetrical regulation, this regulation should not impose unnecessary burdens on one group of regulated carriers as compared with other market participants. Asymmetrical regulation should never be used as a "handicapping mechanism" to guarantee success of a particular provider or group of providers. Regulation should not impose artificial disadvantages on price cap LECs any more than it should on CAPs, cable companies, interexchange carriers, or any other group.

Equal protection under the law demands that similarly situated providers be subject to symmetrical requirements assuring that no provider is handicapped in the marketplace.

---

[90] Implementation of Sections 3(n) and 332 of the Communications Act Regulatory Treatment of Mobile Services, Second Report and Order, GN Docket No. 93-252, FCC 94-31, released March 7, 1994, para. 19.

With respect to the LEC price cap plan, many revisions are required to ensure equal treatment of all providers. Most notable are:

a. Equivalent Pricing Flexibility Should Be Given To All Market Participants.

There is no support in the law for the current policies that allow LEC competitors pricing flexibility while denying the same to the LECs. Two important examples are rate ranges and contract pricing. As recently as March 5, 1994, a SWBT tariff mirroring a CAP tariff that would allow individual case basis (ICB) pricing in response to customer requests for proposals, was rejected by the Commission.[91] Identical tariff language was accepted from a CAP just months earlier. This asymmetric regulation is demonstrably arbitrary and capricious. The LEC price cap plan must be revised to eliminate pricing flexibility disparities between carriers. These disparities hurt market participants through no fault of their own and are not the basis of sound public policy. Likewise, customers are not well served by a policy which arbitrarily precludes pricing flexibility for certain classes of carriers.

b. The Current Rate Structure Should Be Changed.

The current rules dictate the structure of many LEC services. At the same time, LEC competitors are allowed to structure their services in any manner desired by their customers. These requirements clearly handicap the LECs, disadvantage customers, and should be eliminated.

---

[91] Southwestern Bell Telephone Company Revisions to Tariff F.C.C. No. 73, Transmittal No. 2297, Order, (DA 94-204) (Com. Car. Bur. rel. March 4, 1994). Application for Review pending, filed March 8, 1994.

c. Tariff Notice Periods Should Be Modified.

The current rules allow LEC competitors to make tariff revisions on one day's notice. At the same time, LEC tariff revisions can be delayed up to nine months or more in burdensome deferrals and investigations. This severe disparity should also be rectified and LECs should be allowed to meet customers' needs on a timely basis, unencumbered by arbitrary regulation.

d. Provision Of Cost Support And Demand Information Should Be Equalized.

The LECs are required to supply voluminous cost and demand information with many tariff filings. LEC competitors are not. This information advantages LEC competitors by giving competitors vital market intelligence about LEC networks and customers. In addition, lack of this information about LEC competitor networks and services makes demonstration of market competitiveness unreasonably difficult. The Commission should equalize support requirements so that no market participant is unduly burdened or advantaged. Because the Commission truly wants to understand the degree of access market competitiveness, reporting requirements should be established that provide the Commission the necessary data without compromising proprietary provider interests.

e. The Ability To Set Economic Depreciation Rates Should Be Set By The Market.

The Commission currently dictates LEC depreciation rates. At the same time, LEC competitors have no such requirements. The market, not the Commission, should dictate true economic equipment lives.

f. Sharing And Other Disincentives For Investment Impact Price Cap LECs Unfairly.

LECs are required to reduce prices when earnings increase beyond certain arbitrary thresholds. LEC competitors, including AT&T, have no such requirements. This provides a disincentive for LEC investment and should be eliminated. All market providers must have equal incentives to invest in the network.

g. Treatment Of Access Charges For AT&T Should Be Symmetrical.

The NPRM requested comment on the treatment of LEC access charges under the AT&T price cap plan. The current rules are inappropriately skewed against LECs and distort the access markets. Maintaining the AT&T exogenous adjustment in its current form for LEC price changes but not for similar CAP price changes (or for the substitution of CAP and LEC services), places the LECs at an artificial disadvantage in AT&T's consideration of the relative efficiencies of LEC versus CAP network operations.[92]

The status quo clearly is inappropriate. The treatment of LECs and CAPs must be equalized to remove uneconomic incentives. Specifically, the AT&T exogenous requirement should be redesigned to ensure that all long distance customers receive the benefits of lower access rates without causing distortions in access markets. AT&T should be required to include all of its access cost reductions as an exogenous cost adjustment in its price cap formula whether these access cost reductions originate from LEC price changes, CAP price changes or substitution of LEC and CAP services.[93]

---

[92] SWBT Comments, CC Docket No. 92-134, p. 2.

[93] An alternative means of equalizing the treatment of LECs and CAPs is to eliminate the (continued...)

h. Reporting Requirements Should Be Made Equal.

The Commission should adopt minimal reporting requirements by all carriers to facilitate determination of the level of competition in markets. The benefits of providing this information are sufficient to justify the very slight burden on currently nonreporting carriers. All interstate access providers should be required to report to the Commission information that describes the geographic area within which the carrier provides services and a list of those services.[94] This would allow the Commission to determine whether customers in a particular access market have real alternatives to using the LEC's network.[95] In particular, the Commission should require all such providers to file, in conjunction with their interstate tariffs, a description of the area in which they make their service generally available to all customers. This requirement can be satisfied by a general description of the service area (e.g., a listing of zip codes, city or county boundaries, LEC wire centers), or by filing of a service area map. To the extent that the Commission does not require interstate common carriers to file service area descriptions or maps with their tariffs, or to the extent that alternative access providers do not make their services available to all customers in an area, the carriers should file on an annual basis detailed maps showing their network facilities within each area they serve, including planned additions for the following annual period.

---

[93](...continued)
AT&T exogenous requirement. If this requirement were to be eliminated, AT&T should still be required to pass through any decreases in access rates accompanying increases in the EUCL charge. This would ensure that long distance prices are reduced to end users.

[94] The LECs already provide this information.

[95] The LECs themselves generally do not have access to such information for other carriers.

In summary, the Commission must ensure that the revisions to the price cap plan eliminate current asymmetrical regulations and policies that handicap the LECs and disadvantage its customers. To do otherwise would deny the LECs "equal protection" under the law.[96] Regulation should not pick winners and losers by providing artificial advantages to some market participants. The changes to price cap regulation listed above are a requirement if consumers are to reap the benefits of competition.

7. Service Quality/Infrastructure Development Reporting Requirements Should Not Disadvantage LECs. (Baseline Issues 7A, 7B, Transitional Issue 4)

Price cap LECs understand the importance of service quality. High quality improves productivity and profits and simply is good business. Ultimately, the level of service quality is determined by customer and market demands.

The NPRM acknowledges that there has been no LEC service quality degradation under price caps. The major items measured by the service quality reports filed with the Commission demonstrate that trunk blockage, installation and repair intervals, and dial tone response objectives have been met with a very high degree of regularity and that no erosion of performance has been observed.

The NPRM expresses some concern about variances in residence service quality complaints ranging from a low of 31 complaints per million access lines in the first quarter of

---

[96] Mathews v. DeCastro, 429 U.S. 181 (1976); U.S. Constitution Amendment V; Soon Hing v. Crowley, 113 U.S. 703 (1885); Yick Wo v. Hopkins, 118 U.S. 356 (1886); For Administrative Application, see Garnett v. FCC, 513 F.2d 1056, 1060, (D.C. Cir. 1975). The briefs of Southwestern Bell Corporation in Southwestern Bell Corporation v. F.C.C., (D.C. Cir. Case No. 93-1562) also explain why it is illegal to continue to impose different levels of regulation on competitors in the same markets.

1991 to a high of 45 through the first quarter of 1993, falling to an average of only 24 in the second quarter of 1993.[97] First, the number of service quality complaints per access line, as represented in the data filed quarterly by the price cap LECs in the service quality monitoring reports, show a decline in complaints from the levels of third quarter 1992. Second, this level of complaints (measured per 1,000,000 access lines) represents a rate of only 0.0045 percent to 0.0031 percent. Such very low complaint rates are recognized in virtually all industries as an exceptionally high level of service quality. Third, the complaints data do not contain any information as to whether there was actually a service problem, rather it only reflects the fact that a customer complained. While the price cap LECs give all complaints serious consideration, there is no concrete evidence that service quality problems exist; in fact, the evidence suggests that the quality achievement by SWBT and the other price cap LECs has been exceptional.

During the 1991-93 time period, the LEC networks were tested by hurricanes, earthquakes, flooding and riots and generally performed in a exceptional manner. Specifically, during the spring and summer of 1993, large portions of SWBT service territory experienced severe flooding. SWBT's network and its employees responded in a variety of ways. First, SWBT overlooked the natural disaster exclusion in provisioning Inline® service.[98] Secondly, SWBT waived the installation and monthly service charges for TeleBranch™ service, a service

---

[97] <u>NPRM</u>, p. 10, footnote 19.

[98] For a monthly fee, SWBT offers InLine service which is an inside wire maintenance repair plan whereby SWBT will repair the customer's inside wiring at no additional charge. InLine normally excludes repairs of inside wiring that are caused by natural disasters, such as flooding.

whereby calls placed to a telephone number are automatically forwarded by SWBT central office equipment to another telephone number designated by the customer. Third, SWBT provided customers with a free "second" move -- SWBT waived the installation charges associated with temporary and/or permanent customer relocations (for up to two moves) resulting from the flooding.

The network is the lifeblood of the LECs' business. The price cap LECs remain leaders in technology deployment, as evidenced by their commitments to SONET, ISDN, digital switching, digital transmission lines, Signalling System 7 (SS7) and numerous other technologies. The record establishes the clear focus on quality in the past. It is completely unreasonable to assume that the price cap LECs' approach toward encouragement of high service quality will be any less focused on continued quality improvements in the future.

The importance of high service quality is further reinforced by the bargaining power of the interexchange carriers, which are large, powerful and sophisticated customers that certainly demand high quality and are quick to note any service quality concerns. Recent advertising by the interexchange carriers focusing on their excellent quality of voice transmissions (e.g., Sprint's "Pin Drop" and AT&T's "True Voice") would not be possible without the excellent quality of the originating and terminating access connections provided by SWBT and the other price cap LECs.

The price cap LECs are already at a competitive disadvantage in the provision of access because of the heavy levels of administrative reporting requirements and restrictions on their abilities to meet customers' demands. These disadvantages are imposed on LECs, but not on their competitors. As the inevitable increase in competition continues, the need for additional regulatory oversight of specific service quality reporting and measurement should lessen, not increase, because the marketplace will provide appropriate rewards to those carriers that meet customers' quality expectations. In a competitive environment, customers determine the level of service quality that will be offered. If a firm does not meet service quality expectations, customers switch to alternate providers with higher quality standards. On the other hand, some customers may prefer lower quality at a commensurately lower price. Thus, one of the choices customers have in competitive markets may well be varying levels of service quality, as demanded by customers. The Commission should rely on market forces to determine the appropriate level of service quality customers demand, rather than on mandated reporting.

The Commission should not disadvantage LECs any further by mandating additional reporting requirements for LECs but not for LECs' competitors. Regulation should be symmetric across classes of carriers and not cause unnecessary burdens for regulated carriers. In addition, it would be unreasonable and meaningless to expect the price cap LECs to be the sole source of information regarding service quality reports on facilities that involve multiple carriers, including interconnectors.

8. Frequent Review Should Not Be Mandated. (Transitional Issue 5)

The Commission should not institute frequent reviews of the incentive structure provided to price cap LECs under the price cap plan. As outlined in the SPR paper, efficiency incentives are reduced by the prospect of rate reductions when the price cap plan is renegotiated.[99] The more frequently the plan is renegotiated, the fewer efficiency gains can be expected. When the firms cannot expect the benefits of the plan to be sustained, the

---

[99] SPR, p. 19.

deployment of new technology and innovation are slowed. If a regulated carrier is encouraged to make innovative changes, then incentives for efficiency must be sustained over a period of time long enough to be reflected in capital deployment decisions giving rise to efficiencies.

Efficiency incentives are maximized with a long-term price cap plan under which the pricing formula, specified in advance, is not modified in the near term. Under a long-term plan, the firm is fully responsible for any losses in productivity.

Price cap plans with pricing formulas that are predictable for terms longer than three to five years should be seriously considered. Data presented by SPR indicate that efficiency incentives increase with longer terms. For a 5-year term, efficiency incentives (relative to unregulated markets) are 42 percent, and for a 10-year term they are 71 percent.[100] SPR recommends that efficiency levels of at least 63 percent are required for an optional price cap plan. Thus, regulators should not adjust the pricing formula in a price cap plan until 8 to 10 years in the future. Adopting a policy of less frequent reviews as was done with the AT&T price cap plan, could greatly increase efficiency incentives.[101]

9. Sales, Mergers And Acquisitions Of Exchanges Should Be Reviewed On A Case-By-Case Basis. (Baseline Issue 10)

The existing price cap rules (i.e., exogenous adjustments and the price cap tariff review process) are sufficient to handle any adjustments to price cap indexes that may be deemed

---

[100] Id., pp. 19-20.

[101] Id., pp. 20-21. See also Richard Schmalensee, "Good Regulatory Regimes," 20 Rand J. of Econ. 417 (Autumn 1989) (discusses the trade-off between risk and efficiency incentives).

appropriate by the Commission. Because of the unique nature of specific purchases, sales, mergers or other acquisition activity, each should be reviewed on a case-by-case basis.

10. GDP-PI Instead Of GNP-PI Should Be Used. (Baseline Issue 11)

The Commission should use the gross domestic product price index (GDP-PI) rather than the gross national product price index (GNP-PI) in the price cap formulas. This is a simple change that reduces the administrative burdens placed on the Commission and the price cap LECs and has no material financial effect on the LECs or their customers.

In the 1990 LEC Price Cap Order, the use of a "45-day estimate" of GNP-PI was adopted.[102] Subsequently, in 1991, the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) shifted its focus from a gross national product measure of U.S. economic activity to a gross domestic product measure.[103] At that time, the BEA discontinued publication of the 45-day estimate of GNP-PI, substituting in its place the "preliminary estimate" of the GDP-PI. The BEA continued to publish the "final estimate" of the GNP-PI, but its release is now timed 90 days after the end of each quarter, too late to allow the price cap LECs to incorporate that estimate into their annual access tariff filings. Thus, the price cap LECs have

---

[102] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990) Second Report and Order, para. 50. ("We are adopting the 45-day GNP-PI estimate for use by price cap LECs.") With the passage of time, this estimate is now known as the "preliminary estimate" and is now available approximately 60 days after the end of the quarter, rather than the 45 days anticipated in the LEC Price Cap Order.

[103] Allen H. Young, Alternative Measures of Change in Real Output and Prices, Survey of Current Business (April 1992). GNP measures production by labor and property supplied by U.S. residents, including the factor payments for labor and property supplied by U.S. residents located outside of the country and excluding foreign-owned firms located inside the country. GDP measures production by labor and property located in the U.S., including all output of foreign-owned firms in the U.S. and excluding all output of U.S.-owned firms located outside of the country.

not been able to use GNP-PI in their April 2 annual filings, as required by the LEC Price Cap Order and Part 61 of the Commission's Rules due to changes in estimates and release dates made by the BEA since 1991. Most price cap LECs now use the "preliminary estimate" of GDP-PI in their April filings, and then they are required to make a trivial, but administratively cumbersome true-up filing to reflect the "final estimate" of GNP-PI in a June tariff filing.

In comments relating to the Public Notice on the Tariff Review Plan,[104] USTA requested that price cap LECs be authorized to use GDP-PI rather than GNP-PI to avoid the significant administrative burden and cost of the subsequent true-up to GNP-PI, maintaining that the cost of revising data once GNP-PI figures are available could be avoided without loss of accuracy.[105] In the 1993 TRP Order, the Commission made no changes regarding the use of these indexes, stating that "the exact relationship between these two indexes is unclear at this time."[106]

The recommended change would have absolutely no material financial effect. The price indexes for GNP and GDP (i.e., GNP-PI and GDP-PI) are essentially identical. Appendix GNP compares the two indexes from 1982 to 1993 and clearly demonstrates the virtually identical values of these indexes. Further, as demonstrated in Appendix GNP, the growth rates in the two series are virtually identical. For example, for the period from 4th quarter 1992 to 4th quarter of 1993, GNP-PI and GDP-PI grew 2.84 percent and 2.83 percent, respectively.

---

[104] Public Notice, DA 92-1699, Dec. 16, 1992.

[105] USTA Comments, filed January 6, 1993, pp. 2-3.

[106] Commission Requirements for Cost Support Material To Be Filed with 1993 Annual Access Tariffs, Order, DA 93-192, released February 18, 1993, p. 6.

Based on the clear showing made here, the Commission should utilize this proceeding to make the simple change from GNP-PI to GDP-PI for the price cap LECs.

III. OTHER ASPECTS OF LEC REGULATION MUST ALSO CHANGE.

A. USTA Has Suggested Appropriate Goals For Regulation. (General Issue 1, Transitional Issue 1A)

As technological and competitive conditions have evolved, the LEC price cap plan has proven progressively unresponsive and has become an obstacle to, instead of a facilitator of, the current goals of the Commission's access charge structure. SWBT agrees with USTA that the following objectives be used by the Commission to guide its regulatory actions. These objectives better address the challenges of an evolving competitive access market and will better enable the Commission to continue to satisfy its statutory obligation to protect the public interest.

1. The National Information Infrastructure Should Be Developed. (Baseline Issue 1A)

The National Information Infrastructure (NII) has been defined by the Clinton Administration as "the evolving nationwide network of networks that links Americans and American businesses to computers, databases and consumer electronics that will put vast amounts of information at the user's immediate disposal." The NII should support public network characteristics to facilitate: ease of use; security and privacy; interoperability; reliability and survivability; ubiquity; and service and support.

The Clinton Administration has proposed legislative and administrative reform of telecommunications policy, based on the following fundamental principles: encouraging private investment in the National Information Infrastructure (NII); promoting and protecting